

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: CalSTRS Investment Branch 10 Year
Business Plan Concept Document

ITEM NUMBER: 14

ATTACHMENT(S): 1

ACTION: _____

DATE OF MEETING: July 11, 2001

INFORMATION: X

PRESENTER: Christopher Ailman

EXECUTIVE SUMMARY

Upon coming to CalSTRS, as the new CIO, I suggested that as a \$100 billion investment management company, CalSTRS, should have a long-term business plan to manage future growth. The attached report is intended to serve as a framework for forecasting costs and expenses. This is an initial 10-year straight-line growth forecast. If the format and structure is acceptable, this forecast can serve as a first step in building a comprehensive long-term plan. As part of the annual investment division business plan presentation, I have asked each Director to extend out beyond just a one-year plan and begin to look toward a five-year plan. Those individual plans feed into the long-term plan coordinate with the long-term management objectives for the investment branch.

Background:

To be effective in building a quality investment management organization, it is crucial to have a long-term plan. We would not consider investing in a company, if it did not have a clear business plan for the future. We should also expect the same of ourselves. Clearly future events may change the landscape and would require adjustment to the plan, but by having a long-term plan these shifts are easier to manage. Developing a long-term business plan is relatively new ground for public pension plans, most only plan year to year through the traditional budget process. To the best of staff's knowledge, with this report, CalSTRS becomes only the second State pension fund in the country to develop and use a 10-year business plan.

Discussion:

Assets under management are the key driver of workload and costs. Hence the first charts depict the potential growth of assets based upon the CalSTRS Capital Market Assumptions. The range is based upon one standard deviation of the investment return over the next 10 years. It incorporates the actuary's assumptions on benefits, cash flow, and growth of the other CalSTRS retirement plans such as the Supplemental Defined Benefit and 403(b) plan. The plan does not assume the addition of any new pension programs. Please note that the overall plan assumes the current investment portfolio and activities grow with the assets. It does not include any new programs or significant changes in asset management structure.

CalSTRS 10 Year Potential Asset growth**

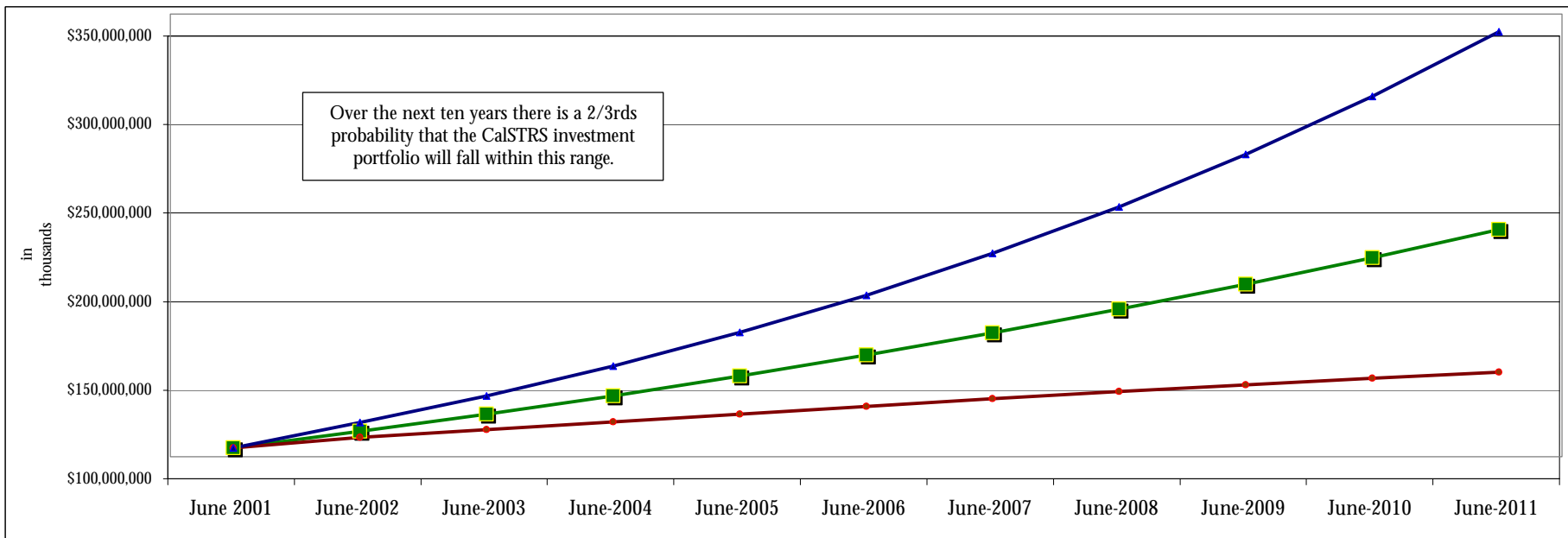
(in Thousands)

	June 2001	June-2002	June-2003	June-2004	June-2005	June-2006	June-2007	June-2008	June-2009	June-2010	June-2011	Assumptions
Retirement Funds (Net)	\$ 105,000,000	\$ 113,783,000	\$ 122,944,253	\$ 132,770,180	\$ 143,275,266	\$ 154,472,316	\$ 166,375,296	\$ 179,002,448	\$ 192,376,671	\$ 206,525,948	\$ 221,478,810	9.10%
Cash Balance Plan	\$ 14,427	\$ 15,581	\$ 16,828	\$ 18,174	\$ 19,628	\$ 21,198	\$ 22,894	\$ 24,725	\$ 26,703	\$ 28,840	\$ 31,147	8%
Supplemental Def. B.	\$ -	\$ 515,000	\$ 1,060,900	\$ 1,639,554	\$ 2,252,927	\$ 2,903,103	\$ 3,592,289	\$ 4,322,826	\$ 5,097,196	\$ 5,918,028	\$ 6,788,109	6%
CalSTRS 403(b) plan*	\$ 54,000	\$ 72,860	\$ 93,417	\$ 115,825	\$ 140,249	\$ 166,872	\$ 195,890	\$ 227,520	\$ 261,997	\$ 299,577	\$ 340,539	9%
Total {less 403(b)}	\$ 105,014,427	\$ 114,313,581	\$ 124,021,981	\$ 134,427,908	\$ 145,547,821	\$ 157,396,617	\$ 169,990,479	\$ 183,350,000	\$ 197,500,570	\$ 212,472,816	\$ 228,298,066	7.45%

*403(b) assets managed outside the Investment Branch and not included in growth estimate.

Low Return Environment**	\$ 105,014,427	\$ 110,778,511	\$ 115,397,829	\$ 119,764,122	\$ 124,133,739	\$ 128,457,844	\$ 132,685,163	\$ 136,764,856	\$ 140,646,542	\$ 144,280,321	\$ 147,611,796	5.00%
High Return Environment**	\$ 105,014,427	\$ 119,390,098	\$ 134,403,103	\$ 151,263,794	\$ 170,141,014	\$ 191,250,426	\$ 214,835,901	\$ 241,176,215	\$ 270,589,616	\$ 303,439,004	\$ 340,132,774	13.20%

**Return assumptions based on PCA's capital market Assumption for 10 year growth. High and low estimate based on 10 year standard deviation for CalSTRS current asset mix.



This forecast is based upon the current CalSTRS capital market assumptions over the next ten years. Actual result will vary widely. Since this chart is based upon a ten year average, individual years return can and will vary significantly. Individual The purpose of the chart is to help explain only a portion of the potential growth in the investment portfolio. Asset allocation shifts and changes in the assumption will move the chart. As described above this only includes one standard deviation, or two thirds of the potential outcomes. this information is for estimation of the CalSTRS business plan and should not be used for any other forecast without the consultation of the CalSTRS Investment Branch.

The next table illustrates the costs borne by the three investment branch budgets, the CalSTRS budget, continuous appropriation budget and the soft dollar budget. All totaled, current costs range at just below 9 basis points and eventually decline to 8.45 basis points. Most of the decline is based on the assumptions that as assets grow; external investment manager fees will decline due to the economies of scale. Since the investment portfolio is designed to generate 9.1% or 910 basis points, the total cost of less than 9 basis points is minor by comparison. This doesn't diminish the fact that the total cost of \$95 million is not a small sum of money, but a corporation could only dream of a 99.01% profit margin.

The significant driver of costs is the external management fees of \$81 million, which represent 80 percent of the total budget. The next largest costs to the portfolio are only one-twentieth the size; investment staff salaries at \$4 million and the custodian cost at \$3 million. The enormous weight of external management fees, compared to staff costs, illustrates one aspect of the trade-off between internal and external management. The plan does include a growth in personnel, as measured by personnel years (PY's.) Studies of other large public pension plans have shown a consistent and positive correlation between assets and investment professionals. At CalSTRS' present size, the average fund would have between 50 to 100 professionals depending upon the percent of assets internally managed. CalSTRS currently has 49 investment professionals.

Future costs will be greatly influenced by the costs of external investment management. The CalSTRS budget costs will be influenced by employee compensation costs. The soft dollar budget will be affected by the cost of technology and investment research. The format of the plan allows for several variations and options. Looking forward, major issues will be the addition of any new, internal vs. external management of assets, and the creation of new investment products. If the format and structure as acceptable, staff will begin to design and cost out various business plans and options for the Committee's consideration. With any plan the ultimate goal is not the management of the investment branch, but rather generating a strong consistent return. Staff believes this type of planning and forethought will help the Committee and senior management design and manage an investment operation to meet the overall CalSTRS investment objectives.

Since this is the first long term cost plan for CalSTRS, staff desires the Committee's input and feedback. The next step in the process will be to build in the expected revenue from the investment program based upon the asset allocation assumptions. The comprehensive plan can then serve as a foundation for future discussions.